Power Sector Privatization in Central/ Eastern Europe and Eurasia: A Summary Report

Based on the:
Conference on Power Sector Privatization in Central/Eastern Europe & Eurasia: Results and Future Plans
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Prepared for the United States Energy Association by:
Catherine R. Connors
Pierce Atwood
One Monument Square
Portland, Maine 04101

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INTRODUCTION

This paper is a summary of experiences and best practices of electric utility privatization in Central and Eastern Europe and Eurasia. It summarizes the conference on **Power Sector Privatization in Central/Eastern Europe and Eurasia: Lessons Learned and Future Plans**, conducted in Budapest on June 6-8, 2000. The Conference, sponsored by the United States Agency for International Development (USAID) and the United States Energy Association (USEA), brought together for the first time key participants in the privatization process. Attending were parliamentarians, ministers of energy and privatization, regulatory authorities, senior state-owned utility executives, private strategic investors, investment bankers and multilateral financial institutions.

During the two and one-half day conference, discussion focused on strategic privatization of the electricity sector in the economies in transition and identified the lessons learned and best practices for the benefit of future privatization efforts. Countries in attendance represented three groups: (1) those with some privatization completed, (2) those in the process of implementing privatization; and (3) those with privatization policies and plans in place or development. Countries represented at the Conference were Lithuania, Latvia, Poland, Hungary, Bulgaria, Romania, Macedonia, Bosnia, Ukraine, Moldova, Georgia, Armenia, Kazakhstan and Kyrgyzstan.

The participants generally agreed that the primary goal of electric sector strategic privatization is to restore and improve the system to provide reliable least-cost and environmentally sound electricity. Further, the participants agreed that this is best accomplished though the establishment of a clear and transparent process for privatization that leads to the purchase of state-owned assets by **qualified strategic investors** that possess the financial, commercial, managerial, technical expertise and international experience to own and operate electric utilities in a transparent market-oriented manner.

A key finding of the conference was that to successfully attract qualified strategic investors, the government must establish from the outset (1) the proper sector conditions and (2) sound privatization policy and process. First, the proper electricity sector reforms are needed such as (a) monopoly unbundling and establishment of a well defined electricity market, (b) establishment of a legal framework, and (c) development of a competent autonomous regulatory body with substantial authority. Second, a sound privatization policy should provide strategic investors with **financial and managerial control** of the assets (at least 51% ownership) and a sound, transparent and timely process.

Taking these steps will assist the country in meeting several other objectives commonly associated with privatization, including:

1) Improving access to private capital resources for the rehabilitation, replacement and eventual expansion of the electric power infrastructure;
2) Improving access to new technology and management practices designed to improve the performance of the sector;

3) Reducing corruption through the introduction of commercial practices which will lead to strengthened collections, transparent and accountable delivery of electricity and reduced political interference in commercial operations; and
4) Improving customer service and customer choice through continued reform of the power sector as a result of innovation and reform introduced by the new owners.

The participants discussed a wide range of policy, institutional, organizational and procedural practices best suited to meet the privatization goal and objectives discussed above. Among the topics addressed at the conference were:

1) Setting appropriate privatization objectives;
2) The relationship between the creation of stable and transparent legal/regulatory institutions and the ability to attract private strategic investors;
3) The timing of privatization and its relationship to the introduction of competition in the sector;
4) The preferred sequencing of the sale of generation, transmission and distribution assets;
5) The role of various government entities in the privatization process;
6) The selection and role of the investment banker as advisor to the government in the privatization process; and
7) The process and schedule for the actual implementation of the privatization procedure including the importance of prequalification of potential strategic investors, selection of the winning proposal, negotiation and the provisions of the sales contract.

The conclusions from these discussions are set forth below in two parts: (I) Key Elements of Power Sector Strategic Privatization, and (II) The Privatization Process. As these two titles reflect, experience shows that certain common, if not universal, principles apply in achieving a successful privatization. While the details of how and why a privatization goes forward can vary depending upon country circumstances, many traits are shared in successful sales of energy assets, and lessons have been learned that can be applied to increase the probability of success.

I. Key Elements of Power Sector Strategic Privatization

The following general conclusions, discussed in more detail below, drive privatization in the energy sector:

- The ultimate purpose of a privatization is to improve the overall efficiency and reliability of service. Objectives of privatization supporting this goal include gaining access to private capital and new management skills, reducing corruption, and fostering further rationalization of the sector through policy reforms that improve incentives for good performance by new owners;
- Attracting international strategic investors is critical to achieving privatization objectives;
- Strong political will to overcome entrenched interests is necessary to ensure a successful power sector privatization;
- Creating a stable, understandable legal and regulatory framework is a prerequisite for attracting qualified strategic investors;
- Risk is relatively high compared to other regions of the world. It is important for each country to make their sale stand out from the crowd. This is best accomplished through the reduction of risk to investors through sound sector policies and by adopting open and transparent procedures for privatization and the ensuing regulation of privatized assets;
- Privatization has multiple audiences, all of whom should be reached and informed; and
- Successful privatizations share many common procedures.

A. Privatization Goal and Objectives

A successful privatization can contribute to balancing the national budget, strengthening the balance of payments, diversification of the economy, and demonstrating the value of a transparent public process. But the primary goal of power sector privatization is to restore and improve the system to provide reliable least-cost and environmentally sound electricity service. Privatization achieves that result by supporting several objectives commonly sought by governments seeking to improve sector performance. Among these are (a) increased investment; (b) improved commercial operations including increased collections and reduced corruption; (c) introduction of modern management technology (metering, billing and collections, accounting, etc.) (d) human resources development, and (e) improved environmental performance.

B. The Importance of the Strategic International Investor

The conference participants expressed a preference for privatization through the strategic investor approach as opposed to mass privatization or portfolio investors. In doing so, the participants recognized that an important benefit of the strategic investor approach is its ability to import experience using modern managerial systems employed in similar utilities elsewhere in the world.

In nations with transitional economies, this preference will generally require the strategic investor to be an international entity with significant experience operating outside of the region.

This does not mean, however, that any foreign investor is acceptable, or that domestic investment should be completely foreclosed. Privatizing countries should aim to attract those strategic investors with financial capability, technical expertise, proven experience and global reputations to protect.

First, a sale to strategic investors brings investment in existing infrastructure. There is a significant need in the power sector of transitional economies to refurbish, rehabilitate and/or replace existing plant that has reached the limits of its useful life. Limited public sector budgets mean infrastructure investments suffer. Privatization provides access to new sources of private capital inflow.

Second, and equally important, investors bring new human resources, personnel management techniques, improved organizational/management structures and practices and modern technology to the sector. This leads to training and improving the skills of existing employees. The introduction of these new management skills can work toward further sector reform as the employees of the new owners push for improved collections, competition, customer choice, and further price rationalization. The initial experience indicates that strategic investors promptly pay employee back wages and taxes (Moldova, Georgia).

Third, the introduction of standard commercial practices by strategic investors can be an effective method of reducing corruption in the electric power sector. This is accomplished by improved collections, selective cut-offs for non-payment and replacing entrenched interests with owners motivated by efficiency and profit. Sound autonomous regulatory oversight can re-enforce these efforts in balancing the interests of both the investor and consumer.

Finally, the strategic investor can be an important proponent of further sector reform and rationalization necessary to improve efficiency. This may include pricing reforms through the elimination of subsidies, requiring the payment of debt accrued by public sector consumers, and innovations in market structure such as the introduction of customer choice and competition.

The participants noted that balance between risk and reward is a strong determinant in the ability of a country to attract a large number of potential qualified strategic investors. When weighing investment in the power sector of nations with transitional economies, potential strategic investors are confronted by a number of legal, commercial, political, and regulatory risks. The mobility of capital and the increasing number of choices in the privatization marketplace provide an investor with a number of investment options. A risky investment climate will limit the interest in a power sector privatization in that country, reducing the number of qualified bidders and lowering the price offered by interested bidders.

Perhaps even more crucially, participants stressed the need by potential strategic investors to obtain management control of the utility and to have the right to obtain majority ownership of the shares of the privatized asset. These rights significantly reduce aspects of commercial risk related to daily decision making as to management of the asset. Nations that do not offer majority shares and management control raise the risk profile of the privatization, and limit both the number of potential bids from strategic investors and their offering price.

C. The Importance of the Proper Power Sector Framework

1. Market Restructuring

The adoption of a sound energy law that defines the electricity market (e.g., open access) and the regulatory arrangement (e.g., a separate regulatory body) increases the likelihood of success. For example, in Hungary, the government attempted to privatize electricity assets before taking these steps, and failed. It then enacted an Electricity Law and created a regulator, tried again, and achieved a very successful privatization of all its distribution and much of its generation assets. The Law, however, did not anticipate the possible need for competition in the future structure of its electricity market. Consequently, introducing competition, necessary for accession to the European Union, is proving difficult and creating uncertainty for investors.

This legal privatization preparation involves legalizing private ownership, spelling out how the privatization will proceed, and setting forth the post-privatization ground rules. Included in this last category should be laws describing the structure of the privatizing country's energy market, *e.g.*, treating issues such competition and open access to the transmission system (third party access).

To privatize, the assets being sold should be packaged into appropriate components. Typically, preceding the privatization process one public, vertically integrated utility is unbundled. The assets are divided and packaged into logical, saleable units (with the assistance of advisors). Knowing in advance the structure of the energy market that is envisioned assists the government in packaging these assets for sale, and provides the investor with a clear understanding of the characteristics of the new energy market in the post-privatization environment.

Additionally, experience teaches that some specific organizational issues should be dealt with prior to privatization to avoid problems later. For example, certain baseline structural requirements exist for participation in the EU energy market. If a government makes long-term purchase or tariff commitments to investors, difficulties could arise if compliance with the EU's directive on liberalization of the electricity market will conflict with such commitments. This issue is known as the "stranded cost" problem – investments that become "stranded" due to additional structural changes in the sector after privatization, such as the introduction of competition. If a government commits to a long-term power purchase agreement with the acquirer of generating assets, problems can arise if subsequent changes in the market reduce or eliminate the ability to transfer the cost of that agreement to a captive customer base.

Hence, at least the general understanding of the ultimate market structure should be reflected and accounted for in the legal and regulatory framework before privatization starts. If the ultimate goal is to eliminate captive customer bases, then the laws and regulations should be designed with that goal in mind, with a transitional roadmap leading up to that final situation. The process and packaging of the privatization of energy assets should then respond to that market structure.

In determining what market structure to adopt, as a general rule, the trend now is toward a bilateral market allowing for direct competitive contracts between distribution and generation

companies, supplemented by a balancing pool to provide incremental quantities and ancillary services. The legal and regulatory framework should allow for the existence of bilateral contracts between consumers and suppliers, complemented by a pool to deal with spot market needs.

2. Legal and Regulatory Framework

Preceding a privatization with the creation of the appropriate legal and energy regulatory environment is a practical requirement and an economic one as well. As noted above, a key guiding principle that all countries should keep in mind in making any privatization decision is **risk reduction**. Every investment involves a risk premium. The lower the risk of an investment, the higher the price that a purchaser will pay, and the more bidders the privatization will attract. Endowing the regulatory agency with appropriate authority and an adequate degree of autonomy reduces the level of political interference in the regulatory decision making process, thereby increasing the level of predictability for the investor and reducing potential risk.

Safeguards of regulatory autonomy that will interest investors include:

- A separate legal mandate creating the regulatory agency and defining its functions vis-à-vis various government ministries;
- Freedom from ministerial control;
- Professional appointment criteria for energy regulatory commissioners;
- Fixed-term appointments and protection from arbitrary removal from office;
- Staggered terms for commissioners; and
- Reliable funding sources for the agency such as licensing or franchise fees that reduce the dependence of the agency on the budget authority of the central government.

To mitigate risk, the participants agreed that the power sector privatization must be preceded by the creation of a strong regulatory agency endowed with independence and characterized by openness and transparency in its decision-making process. For example, in Moldova, where Union Fenosa purchased three of the five national distribution companies in February 2000, a national regulatory agency was created in 1997, followed by an energy framework law in 1998, that provided the legal basis for the regulator. The regulatory agency was charged with a set of clearly defined tasks including licensing, tariff setting, and promotion of competition and consumer protection. The jurisdiction of the agency was reinforced by the Law on Electricity promulgated the following year, which detailed the jurisdiction of the relevant ministries, utilities and the regulator a full two years prior to privatization.

A strong and competent regulatory authority provides investors with a level of comfort regarding the rules of the market place, the procedures for amending tariffs, and the performance criteria for obtaining and retaining license authority, which are significant regulatory risks of concern to strategic investors in the post-privatization period. Together with a well-understood process for conducting the privatization, a competent regulatory authority is one of the most important factors in reducing the level of risk perceived by qualified strategic investors.

Predictability is a key to investor confidence. If the investor understands the rules; has confidence that they will not change and knows that it will be treated equally under these rules; recognizes that the rules will be applied by an independent regulator, with no vested political

interests, the investor will perceive a reduction in risk and should adjust its purchase price accordingly.

Importantly, the investor knows that after the sale, the government will withdraw, leaving only the regulator to deal with on a day-to-day basis. At that point, the investment has become immobile and the investor is committed. Hence, it is crucial that the regulator inspire confidence in the investor, and have the authority to make decisions in principle areas of interest: setting or enforcing tariff methodology and pricing; licensing and monitoring new owners; and consumer protection.

D. Political Will

The conference participants were unanimous in their discussion of the need for strong political commitment for power sector privatization to succeed. The need for political will cannot be overemphasized, as it requires the government to make difficult and politically challenging choices that affect powerful interest groups in society, including government ministries, labor unions, industrial customers, and the public at large. While these groups often have difficulty coalescing, they potentially can unite in their opposition to power sector privatization. The participants stressed that it is important to recognize these important "audiences" for privatization, and noted that they must be informed and communicated with throughout the privatization process, in order to reduce opposition and strengthen political will.

Most importantly, the participants noted that a strongly worded law on privatization, together with the creation of a competent privatization agency and strong regulatory authority, can be effective tools for creating the political will necessary to combat interests entrenched against privatization.

Finally, the participants agreed that power sector privatization is a process that requires the support of, but that cannot completely delegated to, bankers, the privatization agency, and the regulator. It involves a joint effort of many parties, supported at the most senior level of government by committed political leadership.

E. Competition for Investors

Investors will choose their investments carefully, and a privatizing country must compete for investor interest. The need to show how a particular privatization stands out from the rest is particularly acute now that strategic investors have gained experience in purchasing privatized assets. They have grown wary from unanticipated obstacles after their purchases, and are looking for an investment environment that reflects an understanding of and responsiveness to investor needs. The more the privatizing country can demonstrate to potential investors that it knows what they are looking for and that it is prepared to offer them a fair opportunity to make a reasonable return, the more interest the privatization will generate.

F. The Privatization Audience

While speaking to and attracting potential investors is obviously key, as noted above, the privatizing country should not forget that other audiences are also important.

Consumers may face higher prices after a privatization, as subsidies are reduced, investments made and tariff reform, put off due to lack of political will, gets implemented. Workers and managers worry about job security and possible job loss as the privatized entities become more efficient. It is important for the government to explain how these short-term hardships will be addressed and are worth the long-term gains. These issues can be addressed in negotiations. The participants agreed that countries must not only sell privatization to potential investors, but to their own populace as well.

Donors are also an important audience. The European Bank for Reconstruction and Development and the International Finance Corporation can purchase equity and lend to new private owners, which may encourage investors. Clearly, loan conditions can affect and shape privatization. Countries must work with donors and lenders to create a dialogue, communicate needs, and instill confidence in the donor or lender that contributions will be used effectively.

II. Privatization Process: Making Privatization Work – Key Issues & Approaches

With all the factors discussed above in mind, certain specific steps have emerged as most likely to achieve success. This section discusses what these steps are, why they are taken, and how they are advanced.

A. An Open and Transparent Process

It is important to establish an open and transparent privatization process that is organized by the country's privatization agency, with the assistance of experience international investment bankers. To ensure that the final list of bidders is limited to qualified strategic investors, it is important to subject all potential bidders to a pre-qualification process using stringent financial and operational criteria. A pre-qualification round is efficient, screening out entities that do not possess the financial capability, successful commercial experience; operational, technological and managerial expertise and experience needed for the development of the region's power systems. Bids that are received in the second round of the pre-qualification screening come from companies that possess the requisite capabilities necessary to meet the objectives of the privatization as outlined by the country in its tender documents. Such a two-tiered process, with a pre-qualification round first, allows the country to concentrate its efforts more efficiently, by focusing on attracting bidders in the first round, then meeting the qualified bidders' due diligence needs in the second round.

While the existence of a workable legal and regulatory framework is critical, this need should not lead to delay. Perfection is never achievable, so the government should not wait forever, fine-tuning its laws, before going forward.

Nor should the government attempt to micromanage through its laws and regulations. Flexibility must be maintained in order to respond to individual situations as they arise. For example, it probably does not make sense to include an immutable timetable and detailed procedures in the laws and rules governing a privatization. Certain overall parameters are helpful, but room must be left for flexibility and to extend a deadline if warranted under the circumstances.

Finally, as discussed above, experience teaches that the regulator should be as independent and knowledgeable as possible. Investors want regulators who will not be beholden to short-term political demands. The more competent a regulator, and the more divorced the regulator is from the political concerns, the more likely an investor will gain confidence in the legal environment, increasing its interest in participating in a privatization. As a key player, the regulator should be involved in the privatization process from the beginning. It should play a role in determining the market structure and in identifying the objectives of the privatization.

The regulator, however, should not choose the winning bid. It must maintain its distance during the privatization process to ensure that it does not compromise its regulatory autonomy.

B. Sale of a Controlling Interest

Generally speaking, the privatizing country in a transitional economy should sell a majority stake sufficient to provide full management control in the company being sold.

Because one primary reason for privatizing is to bring in modern management and operational expertise, it is important to give the purchaser operational control. The government is exiting the role of management, and leaving the operation of energy sector assets to private entities with knowledge and experience in competitive markets.

Beyond management control, however, the privatizing country should sell a majority and controlling[1] ownership interest in the assets being sold. This is because, first, selling a majority stake increases the attractiveness of the sale and hence the price investors will offer. Second, as noted, one purpose of privatization is to transfer decision making to the investor. Finally, experience teaches that the use of a "Golden Share" by a government to retain some theoretical control over the entity is rarely if ever in fact exercised and may discourage investors.

The government and public interests can be protected through the creation of sound policies to which sector participants should adhere, with the energy regulator and anti-monopoly body the primary organizations overseeing the sector. With the proper legal and regulatory framework in place, the government should no longer have the need to retain ownership or management control over the privatized assets.

Some governments have provided small shareholdings to management and employees to give them incentives to improve the companies and share value.

C. Order of Sale

Generally speaking, distribution should be sold before generation (unless both are sold simultaneously).[2]

[1] In some countries, e.g., Armenia and Ukraine, more than a 51% interest is needed to control a corporate entity.

[2] In practice, transmission has not yet been sold, although at least some countries (*e.g.*, Hungary) have indicated an intent to do so and Georgia will employ two private management contracts for transmission/dispatch and market operations. As a logical matter, nothing should prevent the sale of

The reason for this order of sale is simple. Typically, there is an immediate need to improve cash flow and collections from the consumer. Once distribution is privatized and the flow of funds from the consumer is stabilized and transparent, the generator is in a better position and has greater assurance of being paid. At that point -- after distribution is sold and improved -- the attractiveness of the generation assets is heightened; increasing the interest investors will have in them.

The experience in Kazakhstan is instructive. There, generation was sold first. Collection problems persisted thereafter.

In countries without collection problems, the need to sell distribution first is not as acute. Given that the ultimate goal of privatization is to improve service, however, it can make sense as a general matter to start such improvements at the retail level.

In countries with critical electricity supply problems, it may be necessary to allow some cross-ownership. Distribution companies may want to own generation to assure supply to their customers. This requires effective and consistent regulation.

D. Re-aggregation

Creation of a competitive market begins with the unbundling of the vertically integrated monopoly, creation of the new market for buying and selling electricity and then selling unbundled components. While some re-aggregation of the unbundled components after sale is not necessarily harmful, countries must be careful not to allow investors to abuse a monopoly position by maintaining a sound regulatory approach.

Even in a natural monopoly setting, breaking up assets can make sense. For example, an argument can be make in favor of having multiple distribution companies, even though distribution wires are natural monopolies, in order to set comparison benchmarks. While Distribution Company #1 may have an exclusive franchise over the northern part of a country, and circumstances may differ from region to region, having separate distribution companies for the eastern, southern and/or western parts of the country can allow for at least some general performance comparisons. Comparison with operations in neighboring countries may also be useful.

In the end, the particular bundle of assets sold in one package and the re-aggregation allowed is a function of the specific circumstances of the sale and the country. For example, the country may simply be too small to make multiple distribution companies feasible. Or, the alternative of precluding an investor that has already bought assets from purchasing another set of assets may be worse than such re-aggregation.

Consideration needs to be given as well to the potential negative impact of aggregation on competition in regional electricity markets. As electricity exports and imports expand over

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transmission assets, and such assets are held by private entities elsewhere. While transmission wires are often viewed as strategically important to a nation, such importance should not foreclose transfer of ownership to an appropriate, regulated strategic investor.

time and regional electricity markets emerge, cross-ownership of generation and distribution may lead to resistance to importation of cheaper electricity.

E. The Role of Participants: In-Country and Advisors

The following is an illustrative description of in-country participants in the power privatization process:

- The Government and Parliament
  - Design the overall sector framework (e.g., the market structure) and privatization framework and adopt into law

- The Cabinet
  - Approves privatization strategy
  - Sets deadlines

- Energy Ministry or Department
  - Develops strategy for sector reform and privatization
  - Government holder of management rights
  - Assures cooperation of power companies with privatization process and potential bidders

- Ministry of Finance/Economy
  - Defines budgetary requirements for privatization revenues
  - Interacts with multilateral financial institutions on financial and sectoral conditionality

- The Privatization Agency
  - Primary implementation entity to oversee the process including pre-qualification, tender issuance and receipt of bids
  - Approves the winner based on tender committee evaluation process and negotiations

- Companies to be Privatized
  - Prepare information and meet with investors

- Tender Committee (can be comprised of representatives from several areas of government, including the parliament, ministries of economy, finance, energy and others)
    - Reviews the analysis of the privatization agency and the investment banker
    - Selects the winner
    - Negotiates with the winner

- Regulator
    - Advises on industry structure and market and privatization strategy, particularly as it relates to tariffs and license issues
    - Provides input to preparation of tender documents

- Provides regulatory information to bidders
- Not a Tender Committee Member, but may advise privatization agency and Tender Committee in process and negotiations while maintaining regulatory autonomy
- Makes final decisions on tariffs and licenses
- Balances consumer and investor interests

The tasks outlined above for each of these participants are reflected in the legal and regulatory framework, and flow from their authorities. Political officials develop policy, because policy involves political decision-making. Ministers, the Privatization Agency and Tender Committee are administrators charged with implementing that policy. Finally, the regulator, as the entity that will be overseeing the purchaser after the sale, should be involved from the start but maintain its autonomy and not be directly involved in the selection process, except to act as a source of information and technical expertise.

As the subsequent day-to-day overseer of sector operations, the regulator may have a different perspective from the others. For example, the government may be concentrating on receiving an optimal sales price. The regulator, looking ahead and in keeping with one of its usual ongoing duties -- consumer protection -- may be more concerned with lower tariffs or initial infrastructure investment than assuring that the most money goes to the government's general budget. A successful privatization should balance all these interests, while retaining the political will to focus on long-term gains.

Aside from these in-country participants, it is crucial to hire outside advisors. The privatizing country should retain an internationally experienced and well-known investment banker to guide the process. Such an advisor has the experience needed to carry out a privatization, credibility with potential investors and is less subject to domestic political interference. Advisors are typically chosen through a competitive bid process.

In selecting appropriate advisors, it is crucial not just to choose a firm with a strong reputation, but to insure that the individual personnel from that firm assigned to the privatization is knowledgeable and experienced. This means not only general privatization experience, but also an understanding of the sector and circumstances affecting the individual country and that particular privatization.

Given the importance of selecting a good advisor, the key in choosing one should not be cost, but rather the reputation and experience they bring to the project. Typically, they are paid through a combination of a fixed retainer fee plus a success fee (*e.g.*, 1-5% of the sales price).

F. Timetable

Experience teaches that the needed steps in a privatization (discussed in more detail below) should follow this approximate timeline:

1. Select advisors - 2-3 months
2. Document preparation/initial marketing – 2-4 months
3. Pre-qualification - 1 month
4. Due Diligence/Bid Preparation and Submission - 3 months

5. Selection of winner - 1 week
6. Negotiation with winner – 1-2 months

Specific dates can vary and should be flexible within limits. The key is to strike a proper balance in order to keep maximum investor interest. Enough time should be devoted to each step to ensure that the potential investors have had the opportunity to participate. On the other hand, care should be taken not to delay too long at any step and lose momentum. Every effort should be made to hold to schedules. Delay means increased cost to bidders and potentially decreased bids or withdrawal from the process.

G. The Sale Process

1. The Launch

The launch of a privatization should begin with preparation of the documentation and effective and targeted publicity.

Good publicity is important to single out a country's privatization from the others that may also be bidding for investor interest. This publicity should be geared toward attracting the strategic international investor. Hence, publicity should be focused and aggressive.

The Moldovan distribution sale experience is instructive. After announcing that it would sell its distribution assets, a Moldovan delegation generated awareness of the sale by holding a briefing conference in London to answer questions from the press. The delegation then met with potential investors to provide more detailed information. These steps showed that the government was committed to the privatization and had an understanding of investors' needs.

Advisors can and should be used in the publicity process. As experienced participants in past tender processes, they can educate the privatizing country on what potential investors are looking for and how to attract them.

2. Tender Versus Negotiation

A competitive bid process versus negotiation is preferred. Simply approaching potential investors individually not only reduces transparency, but creates the risk that the good potential investors may be overlooked.

For example, in one privatization, Kazakhstan identified potential purchasers and approaching them for direct negotiation, rather than requesting competitive bids. This method was expected to have the advantage of reducing the time between the decision to sell and the actual closing. Ultimately, however, it does not appear that this direct, targeted contact method resulted in quicker sale. This method also limited the field of potential purchasers and transparency.

3. Two Phases: Pre-Qualification and Bid Preparation/Submission

As noted above, typically and preferably, the bid process is carried out in two phases: (a) pre-qualification, followed by (b) bids from qualified investors. The reasons for this two-staged timing are multiple. First, it allows the privatizing country to assess interest in the first round, without wasting the time and resources. It allows assessment of interests and investor needs, along with an opportunity to modify the process, re-package the assets, revise the schedule, and work on improving the background situation to address investor concerns.

Second, the pre-qualification round can separate out the investors who are truly capable of purchasing, improving and operating the tendered assets, so that the privatizing country can educate and focus on this smaller group of investors in the second round.

Thus, the first round should include professionally prepared information for strategic investors sufficient to attract interest. It should contain pre-qualification requirements sufficient to ensure that the second round is limited to qualified potential purchasers. Pre-qualification criteria are critical and should be clear, strict and difficult to circumvent by unqualified companies and politicized Tender Committees. The criteria should address at a minimum financial resources and management, operational and technology capabilities, demonstrated successful past experience to ensure that the investor has the capability of paying a reasonable sale price and, even more important, performing well after the sale.

Performance standards set by the autonomous regulatory process are generally preferred over rigid investment commitments established in the privatization tender and purchase agreement. Hence, instead of requiring a buyer to invest a fixed amount of capital into the purchased business, the buyer should be required to meet reasonable performance standards, such as a limited number and duration of power outages. The buyer -- the private entity with management and operational expertise – will know how to achieve performance standards at least cost. The Government and consultants may not accurately estimate the appropriate size and timing of investments.

Allowance for investor flexibility in operations and management should be maximized in every area, to the extent possible. For example, if employee retention is part of a bid requirement, the buyer should be allowed options to address this requirement. Instead of mandating that a fixed number of employees must be retained, the buyer should be permitted the option of offering voluntary severance packages. The retention or severance packages required could vary based on a country's economic situation. Simply providing back pay may be sufficient in countries where employees have not received their salary for a significant period of time. In other countries, multiple-month pay packages may be and have been offered. Or, contributions may be required to fund re-training of downsized employees. In imposing such retention or severance requirements, however, the privatizing country must remember that the costs of meeting these requirements will be taken out of the purchase price, and that a large retention requirement with no time limit can eliminate investor interest entirely. This issue is usually worked out in the sale-purchase agreement between the investor and government.

After bidders are pre-qualified, a period of due diligence is critical for the investor to gather information and prepare the bid. It is important for the Government, investment bank and

power companies to provide information to the potential bidders during this period. Among other things, the bid package should be clear about assets and liabilities: what exactly is the investor buying? Whether the state or the buyer assumes existing debt will often be a key issue in the sale. The package should also be developed so that the buyer purchases the assets it needs to function. For example, if in selling a distribution company, a piece of a transmission line is needed for the company actually to operate, then that line should be a part of the sale package. Similarly, the bundle of assets being sold should include the land on which the equipment is located if that land is needed in order to operate the equipment effectively.

Enough time should be given in the second round to allow these bidders to do their due diligence. As with the development of a strong legal and regulatory background, this due diligence process is a risk reduction step to the investor with no downside to the privatizing country. The country's cost of reducing this risk is minimal. Particularly now, after strategic investors have gained experience, they will not invest in a project in which they do not have confidence. They need to see the books of the company being sold. Their questions need to be answered fully and candidly, or they will either reduce their purchase price or not bid. Pre-qualified bidders should have open access to the assets being sold and to current employees. There is no advantage to be gained in trying to hide a cost associated with the assets being privatized. With no information provided on that cost, the potential investor will either discount its price, thinking that the situation is even worse than it is in reality, or will not bid.

When answering bidders' questions, the answers should be available to all bidders, not just the one that asked the question. Each bidder should be treated equally, and should perceive that it is being treated the same as all the others.

H. Selecting and Negotiating with the Winner

If done properly, choosing the winning bidder should only take a short time. Because bidders will have demonstrated they meet the financial, technical and experiential requirements in the pre-qualification stage, a properly prepared tender can rely on a single criterion for selecting the winner: price.

Sometimes some weight is given to purchasers' willingness to buy more than one asset. For example, if all generation is being sold, while one bidder may offer more for hydro-facilities only, another bidder may be willing to buy a package of both hydro-facilities and less valuable generation resources. The latter offer may be more attractive to the selling country, viewing the sector situation as a whole. In weighing this type of "good asset-bad asset" packaging, however, the country should understand that tying the less attractive asset to the more attractive asset could lead to severe downward adjustments in any price offered. It may make sense, therefore, for the country to allow multiple package offers, giving bidders the choice to bid on both single and combined asset packages. While this makes comparison among the bids more complicated, it allows the country to identify better the impact tying assets together has on the overall price.

Requiring a minimum number of bids in high-risk countries may be inadvisable and runs the risk of rejecting a competent reasonable single bid. A limited number of bidders may reflect the high degree of risk. The chances of getting few bids can be minimized by strong Government measures in advance of the privatization to establish a sound regulatory framework, clear

electricity market arrangements, enforcement of cutoff policies, sound treatment of debt obligations, etc. If the initial tender is unsuccessful it is common practice to learn from the experience, make adjustments to attract investors and re-bid the assets.

Depending upon the process employed and the degree of preparation, negotiation with the winner can be complicated. Difficulties will arise particularly when the legal and regulatory framework is not clear. The draft purchase and sale agreement is a critical and complicated document that will be the focus of negotiation. Often when the law is not clear, the investor will have to seek clarity through the terms of the purchase and sale agreement, which can lead to lengthy negotiation. The purchaser knows that the government may lose interest in the purchaser's concerns after the sale completion and payment. Consequently investors want their concerns resolved before the sale is completed.

Often a key issue in these negotiations is tariffs. A purchaser must recover its investment as well as ongoing expenses. An investor may want long-term agreements to assure that it has a guaranteed income for a substantial period of time. Experience to date indicates that limited periods of agreements may succeed but may result in a lower bid price. The Hungarian experience indicates that long-term contracts can have unforeseen consequences, such as forgoing future options that might result in lower electricity costs. Such arrangements may delay the introduction of competition and can interfere with the ability to meet EU requirements.

Finally, no matter how experienced the negotiators and clear the legal and regulatory framework, contract interpretation and other issues will inevitably arise after the sale. Hence, a dispute resolution mechanism should be included in the legal/regulatory/contractual/tariff framework to address these questions. As noted throughout this paper, investor interest and the price offered are tied to the risks of the investment as perceived by the investor. On the one hand, in a country with well-functioning judiciary, an investor will welcome a limited judicial appeal process for most regulatory decisions, in order to assure a check on the regulator's discretion. On the other hand, given the inevitable added costs and time delays, the investor will not want to have to resort to the courts to obtain relief. Hence, with respect to disputes with the government, an investor will prefer arbitration in accordance with international norms to a judicial remedy. With respect to disputes with consumers, *e.g.*, the right to cut-off a non-paying customer, the buyer will also prefer a pragmatic, effective avenue for relief. Hence, the buyer will greatly prefer a legal framework that allows the utility to cut-off the non-paying consumer without having to go to court first, with an appeal route for the customer for mistaken utility behavior. This preference, as with every other risk and cost, will be reflected in the price bid for the asset.

I. Social Impacts

1. Company Impacts

Management and employee concerns about job security or loss can be addressed as part of the negotiations and included in the buy and sell agreement. There are numerous arrangements that can be agreed to that will cushion any changes that will take place. In Hungary and Georgia, the Governments and investors worked out agreements that included, among other things, employment buy-outs and training programs. It is useful to note that not all

transitions are adverse. Immediate payment by the new owners of all back wages and wage increases in the first year have occurred (Georgia, Moldova).

2. Customer Impacts

Strategic investors will introduce commercial practices that will include strengthened collections through modern metering, billing, collection technology and management. Privatization may also mean some increase in tariffs. As a consequence, some customers may be adversely impacted. It is important to identify these impacts and address them from the beginning. In Georgia, low-income households in the territory of the private company were provided subsidies through donor support. A similar program is being implemented in Moldova.

A widespread practice pre-privatization has been toleration of government underbudgeting and non-payment by state budget organizations for electricity (such as water and heat companies, municipal buildings, state industries, etc.). As a consequence, the power sector is forced to absorb the deficits rather than the central and municipal budgets, with the debt building up in the power sector. Privatized companies cannot do this, and governments will have to begin to budget fully and pay for electricity consumed.

CONCLUSION

Strategic privatization can be a strong, positive step in improving energy service even in difficult situations. Because these assets can only be sold once, the privatizing government should take care to do everything it can to maximize the success of such sales. Experience has taught that the actions outlined above can contribute to that success.